Notes on Default Rules and Breach of Contract

There is a long list of possibilities (contingencies) that can be included in a contract. Adding all of them will not only be costly but will also take too much time to consider all of the possibilities, write about them and read them afterwards. Hence, the courts include default rules, or rules that apply when a stipulation about a certain circumstance is not included in the contract. They do the following:

- Allow the contract to be a short-form version of the agreement
- Incentivize the drafters of the contract to write/rewrite their contracts in a certain way
- Serve as a guidance for instances when there is no written rule

However, this does not imply that negotiations should not write contracts. Legislatures can limit/change the rules and limitations on contracts while courts interpret these rules. Nevertheless, contracts are, in many cases, still efficient to have since they are tailored to guide decision-making.

If contracts are efficient, then why do we have contract law? This is because they help *to reduce transaction costs*. They incorporate the implied long-form of the contract. For instance, if there is inefficient behaviors arising from poorly written contracts, courts clarify the stipulations of the agreement to reduce the inefficiencies. Courts try to figure out what the contract would have been (what the parties would have decided ahead of time had they thought of the circumstance under discussion) before they made the official agreement.

Two examples come to mind.

1) During 9/11, the World Trade Towers were attacked and destroyed. The owners of the buildings then tried to claim the insurance for the buildings. The insurance agreement stipulates that they can claim up to $3.5 Billion per incident. Based on obvious incentives, the insurance company claims that there was only one incident (so they "only" have to pay $3.5 Billion) while the owner of the two towers argue that there were two separate attacks (and therefore, two claims should be made instead of one). When the case was brought to court for the first time, it ruled that it should be considered as two occurrences. In another occasion with a different set of insurance companies, the attacks were considered just one under the "use of a temporary form that defined a series of closely related events as one occurrence."

2) In 1956, Nasser nationalized the Suez Canal. This action limited other countries from using the canal. In retaliation, several European countries bombed the canal, making it impossible to deliver anything through it and made some businesses suffer. Shortly before this period, Tsakiroglue had made a contract with Noblee Thori that he will deliver peanuts to Noblee Thori and even insured Noblee Thori for the delivery. Given the Suez Canal incident, if Tsakiroglue decides to deliver the peanuts, he will need to go

around Africa and therefore incur some additional trade costs. Given these arguments, he refused to uphold the agreement. The issue was taken into the international courts and the courts ruled that Tsakiroglue is responsible to deliver the peanuts even if there are much higher and unanticipated costs for him to do so. The courts decided that the contract should be upheld since Tsakiroglue has insured the delivery of the goods. This may be inefficient. Why?

- Going around Africa is much more expensive for Tsakiroglue. If he anticipated the need to do so, he may have asked for a higher price for the peanuts. Either Noblee Thori reduced the order amount or he may have simply gone somewhere else.

- Buyer is thought/assumed to be more knowledgeable about international prices (assuming that he has shopped around). Hence, he should have been liable.

Given this, how do we know who was right in this scenario? We determine who was right by observing how different the contracts that are made afterwards are to the contracts made prior to this case.

Notes on Remedies for Breach of Contract:

1) Specific Performance works well for transfers, usually of physical goods like property. It creates great bargaining power for the side that suffered the breach. In theory, we would have wanted to know what it costs the promised party for not acquiring the transfer but may be difficult to do so. Hence, the promised party should just get what the promised good was, if cost effective to do so. The promised party can then sell it to another if she chooses to do so. If it is not cost-effective to grant the promised good at the agreed upon characteristics, the parties should calculate the loss that the promised party had for not acquiring the good/service. Some examples include the following:

- If B promised A to sell a house for $200,000 but sells it to C for $250,000, there is a breach of contract in which Specific Performance can be applied. Given that there was a contract in place, the easiest solution is for B to nullify his transactions with C and then sell the house to A. However, the more difficult (and perhaps, more costly) solution is to find out the loss for A of not being able to buy the house and be compensated for those losses.

- Another example is when a house was planned to be made. In the plans, the owner stipulated that the plumbing be made with copper but it was instead made with cast iron. Stripping down the house to replace the plumbing will be costly and hence, inefficient.

Instead, the two parties should figure out the loss to the house owner of the mistake and be compensated for it. The payment of loss is a contract.

2) Liquidated Damages are likely to be optimal since both parties agree ahead of time to pay for specified damages. A common example would be highway construction. The contract may stipulate that if the construction is not done by a certain date, each additional day of construction after the specified date may result to a fine for the builder.

Given these potential costs, why would the seller be willing to include liquidated damages in a contract? They do so because the costs are implicitly passed on to the buyers. Hence, the buyers would want an optimal amount of specified damages be included as liquidated damages. Anything over will increase the prices beyond optimal. The buyers may then end up paying more than what the product is worth to them if costly guarantees are made. This follows the logic example below:

- When a plane crash occurs and packages of FedEx sink into the ocean, FedEx is not deemed responsible for them. This is because it is very expensive for them to retrieve those packages. If the courts ruled that they were responsible, they will simply calculate the potential costs for mistakes/accidents and will pass on such costs to their customers. In other words, the increase in costs will translate to increase in prices beyond optimal.

3) Expecting the victim to mitigate damages is also efficient. This is because it creates optimal incentives for both the breaching party and the victim. Similar to other materials discussed before, if the victim finds a breach on the contract, he should try not to cause extra damages since he will be responsible for those extra damages, not the breaching party. An example would be if there is a leak from the bathtub that is weakening the ceiling of the floor below. The victim of the breach is then expected to mitigate damages by not using the bathtub until the leak is fixed.

4) Pre-breach precaution should also be taken up to the optimal amount. This is because not all potential damages are covered by the contract. Frequently, consequential damages are not covered by the injurer since if they had to cover these, their costs would be greatly increased and they would need to also increase their prices. Furthermore, the victim can simply reduce damage at a much lower cost so we expect the victim to also take the optimal amount of care. A scenario includes the following:

- Imagine that we're back to early 1990's and you visited a different country. You decided to take a lot of pictures. You used your Kodak camera that still used the Kodak film rolls. After the trip, you went to the Kodak store to develop the films. If Kodak loses the film, you cannot sue Kodak for the contents of the film (or for another trip to take another set of pictures) but can legally just ask for a replacement of an empty film. Hence, you could

have taken pictures from multiple cameras and develop the films in different stores (some people actually do this to be cautious).

Occasionally, if the victim can do little to reduce the damage and the potential injurer knows what is involved, we expect the injurer to pay for consequential damages. Contracts do not generally have consequential damages aside from contractors and automobiles. For instance, a contractor who is building a house observes the possibilities for damages. They can then make some adjustments with much lower costs.

Example of when default rules make sense

If a few individuals are in grave danger, they would need to find ways to maximize the expected number of survivors. Hence, they might just allow a default rule to occur such that whoever passes away first must be eaten and/or whoever gets sick, in a time of desperation, that person becomes the sacrificed individual. Since there is no prior contract drafted nor any authority figure that enforces legislative as well as judicial rulings, people have to instead follow the industry standards.

Notes on when a handshake is considered a contract:

A handshake is a contract if it is the norm for the industry to establish a transaction through a handshake (e.g. think of the diamonds industry). This is also true if the negotiation is high profile and there are photographs of the handshake as evidence. This is why when Getty Oil and Pennzoil made the deal about the land informally through a handshake, they made a binding agreement since it was a well-known discussion and a photograph of the handshake was taken (a letter of intent was also previously signed by one of the major players of Getty Oil, Gordon Getty). Note that when Texaco made the offer to Getty, it also promised Getty that it would be liable for any legal bills. Because of this reason, Pennzoil sued Texaco for tortious interference with a contract rather than suing Getty for breach of contract.

Notes on the difference between tortious interference and punitive damages

Just to clarify, in the case of Pennzoil vs. Texaco, Pennzoil sued Texaco for tortious damages, meaning that they are seeking compensation for some of the financial damages brought by Texaco's interference in the agreement between Pennzoil and Getty Oil. The punitive damages are also imposed by the jury on Texaco as a punishment for its misdeed. Given that the case is of tortious interference, Specific Performance, which would have been the best way of determining damages since it involves not bothering determining damages at all, is not available.

In the first trial, the Texas jury imposed a very high fine on Texaco, but it may be argued that there is some bias in the decision as Texaco, the defendant, is based on New York and Pennzoil, the plaintiff, is based in Texas. Because of the threat of the appeal and the costs of going through another lawsuit, the two sides finally settled out of court.

Notes on Courts and Contracts

Courts enforce most written agreements and some verbal agreements. They are hesitant to overturn contracts because if they overturn all the time, they should write it instead. This is because drafting contracts can also be costly for the parties involved. What the court is trying to do is the following:

1) Encourage people to read the contracts - even the fine print - while motivating the drafters of contracts to write a transparent and clear contract.
2) Discourage criminal activity by not enforcing contracts that promote criminal behavior.
3) Clarify ambiguities with contracts
4) Provide interpretations of contracts per contingency (give the long-form of the contract)
5) Interpret rules and regulations imposed by the legislature and explain how they apply to contracts